TEACHERS' RETIREMENT BOARD

INVESTMENT COMMITTEE

SUBJECT: Alternative Investments – Urban/Rural, and New and Next Generation – Portfolio Allocation

ITEM NUMBER: 5

ATTACHMENTS: 3

ACTION: X

DATE OF MEETING: October 2, 2002

INFORMATION: ___

PRESENTER(S): Réal Desrochers & Richard Rose

EXECUTIVE SUMMARY

At the July 10, 2002 meeting, the Investment Committee directed Staff to present the asset allocation plan for the Urban/Rural, and New and Next Generation Investment program having a total allocation of $350 million.

BACKGROUND

In February 2002, the Investment Committee approved an implementation plan that was developed by staff based upon a similar program at CalPERS called the California Initiative, as illustrated in Attachment 2. The CalSTRS program would differ from the California Initiative in its smaller allocation, the inclusion of new and next generation managers, and a selection process from within the group of eleven funds already selected by CalPERS.

Since the February Investment Committee meeting, staff has met with CalPERS staff, an independent Private Equity Consultant, several potential fund-of-funds managers, several other independent General Partners who invest in this sector, and the McKinsey staff who worked with CalPERS in developing their California Initiative program. Based on this research, Staff has developed criteria for the selection of managers and a preference for an overall portfolio structure for the CalSTRS program.

Criteria for Manager Selection:

- Manager Track Record: Managers must have a demonstrated history of competitive rates of return and a history of returning capital to investors.

- Management Team: Managers must have a team that has worked together for an extended period of time. Underserved and rural markets are highly specialized requiring direct experience and skills. While there will be consideration of new teams, a demonstrated team history is preferable.

- Investment Strategy: Managers must have a demonstrated network of contacts and relationships to source transactions.

- Alignment of Interests with CalSTRS: Staff believes that the alignment of interests is an essential success factor. Managers must be incentivized to maximize returns. This is achieved by significant investment contributions by the management team based on ability to pay. The management team must be incentivized to remain active with the management of fund assets throughout its lifetime. This is accomplished by having a long vesting period for the team. Finally, all team members should have a stake in the fund's performance. This is achieved through relatively flat sharing of carried interest (capital gain).

Risk Management and Mitigating Factors

Market Risk

- CalPERS has already committed significant assets in these new markets. Attention must be paid to the timing and size of the capital being deployed into the investment opportunity.

Risks for CalSTRS to underwrite

- Track record need not be top-tier, but must be proven, as an offset to knowledge of and experience in the underserved universe.

Risks for CalSTRS to mitigate

- Team risk: In this unique investment area experienced investor teams are preferred. The review will recognize the importance of both team history and success in individuals and groups in prior ventures.

Overall Portfolio Structure

Two key factors had a strong influence on the staff's recommended asset allocation: portfolio diversification, and the ability to provide capital to new and smaller management teams. Good diversification can be attained with exposure to these sectors greater than 40% of the total. Since the targeted investment area does not have a long or deep investment history, and many of the partnerships under consideration are fairly new, there are fewer data points to help design the optimum portfolio mix.

Given the complexity of the urban, rural and new and emerging manager market segment, Staff considers it prudent to diversify across a larger number of managers, who have the skill sets that match closely the required expertise. Thus, Staff believes diversification to be the best risk management tool.

The recommended portfolio mix emphasizes two fund-of-funds structures that would meet both of the key factors. Staff recommends a range from 65% to 40% of assets be allocated to fund-of-funds in this area. Traditionally, the CalSTRS alternative investment program has not selected a fund-of-funds approach in order to avoid a double cost structure. CalSTRS is itself one of the largest fund-of-funds managers. However, in this market segment, the fund-of-funds manager can specialize, devote the time and resources to be "on the ground" with the general partners, and diversify the portfolio by partnership, strategy and most importantly by time period.

The other key consideration was to make CalSTRS capital available to a larger number of new general partners, who by nature of the smaller size of their funds would not otherwise be likely to attract large institutional investors such as CalSTRS. This would allow CalSTRS to monitor the success of the smaller firms, and provides the potential to expand the relationship with new managers to a direct investment as the firm successfully grows.

The other components of the portfolio consist of corporate partnerships, co-investment funds, and middle market and venture funds. These components of the portfolio are higher risk, in Staff's estimation. Staff recommends committing a range from 35% to 60% of assets to these areas, depending upon the risk profile that the Investment Committee wishes to take.

In summary, designing a portfolio is as much an art as an exact science, especially when there are fewer data points to plot a course of action. With that in mind, staff has a plan, but has also included two alternate plans for the Committee's consideration (Attachment 1). Staff was asked to quantify the risk and return of each portfolio mix; unfortunately, this cannot be developed due to the lack of performance data in the asset class. To do such an analysis, even in the core private equity portfolio, creates the potential for vast oversimplification and significant estimation error, which would not, in our opinion, clarify but cloud the issue.

RECOMMENDATION

Staff prefers the attached asset allocation plan. To provide the Committee with choice of two alternate allocations have been included in Attachment 1. Also, attached is a resolution (Attachment 3) for final action by the Board.

Prepared on September 12, 2002 by

_________________________________ Date: ________________

Richard Rose
Principal Investment Officer

__________________________________ Date: _________________

Réal Desrochers
Director-Alternative Investments

___________________________________ Date: _________________

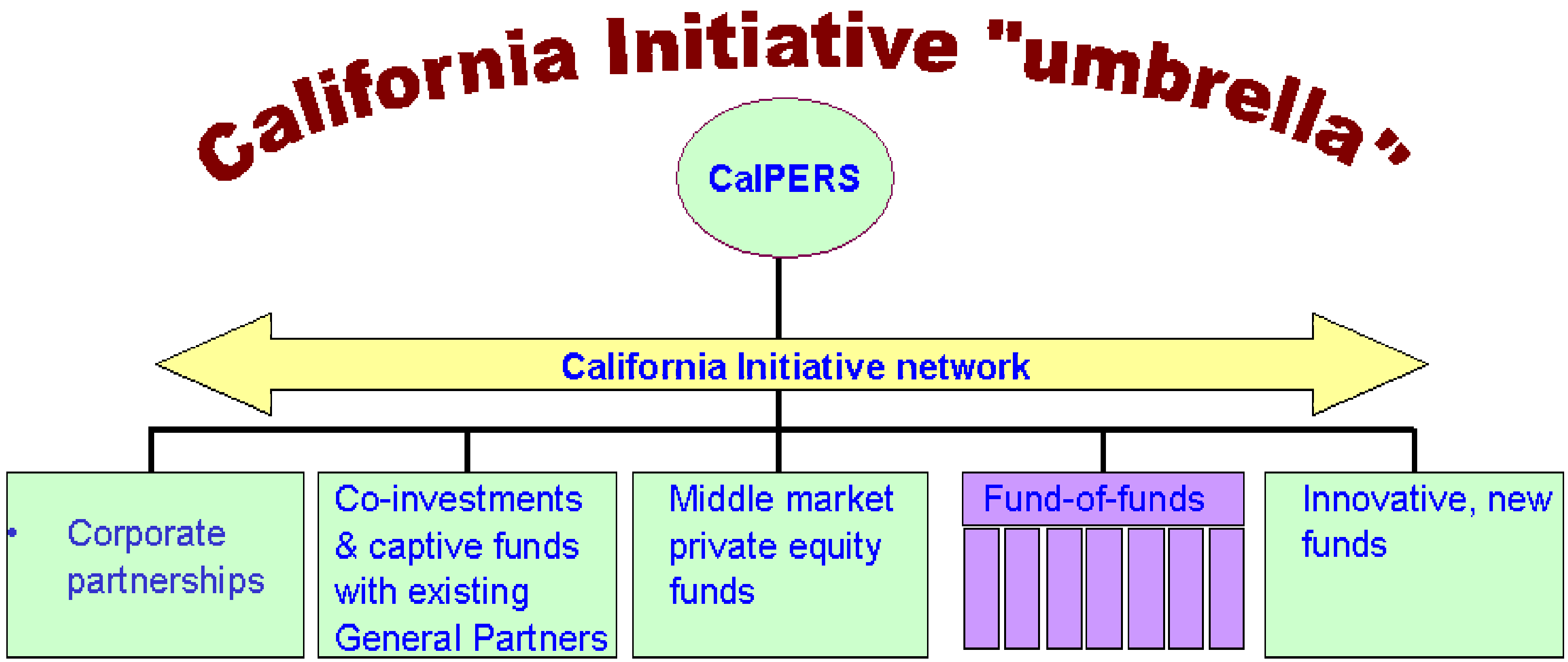
Christopher J. Ailman
Chief Investment Officer

Attachment 1
Investment Committee – Item 5
October 2, 2002

PROPOSED UNDERSERVED URBAN AND RURAL MARKETS, AND NEW AND NEXT GENERATION MANAGERS ASSET ALLOCATION

Type of Investment	Risk Profile	Staff Original Allocation		Alternative Portfolio #1		Alternative Portfolio #2	
Fund of Funds - Urban / rural	lower	$75	65%	$75	50%	$75	40%
Fund of Funds - New / next generation	lower	$150		$100		$70	
Corporate partnerships	higher	$50	35%	$100	50%	$150	60%
Co-investment funds	higher	$50		$50		$30	
Middle market & Venture capital	higher	$25		$25		$25	

Attachment 2
Investment Committee – Item 5
October 2, 2002



Attachment 3
Investment Committee – Item 5
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PROPOSED
RESOLUTION OF THE
TEACHERS' RETIREMENT BOARD
INVESTMENT COMMITTEE

SUBJECT: Alternative Investments -
Urban/Rural, and New and Next Generation – Portfolio Allocation

Resolution No.___________

WHEREAS, the Investment Committee of the California State Teachers' Retirement Board is responsible for recommendation to the Board, investment policy and overall investment strategy for the management of the Teachers' Retirement Fund, a multi-billion dollar public pension plan, and;

WHEREAS, the Investment Committee is charged with developing the Fund's Investment Policies and Management Plan including the policies for individual asset classes such as Alternative Investments, and;

WHEREAS, the Investment Committee has reviewed the Staff Underserved Urban and Rural Markets, and the New and Next Generation Managers asset allocation plan which was presented to the Investment Committee on October 2, 2002; and Therefore be it

RESOLVED, that the Investment Committee direct Staff to invest $350 million and approves the following asset allocation plan for investing in underserved urban and rural markets, and new and emerging managers:

Type of Investment	Allocation
Fund of Funds - Urban / rural	
Fund of Funds - New / next generation	
Corporate partnerships	
Co-investment funds	
Middle market & Venture capital	
Total	$350 million

Adopted by:
Investment Committee
on October 2, 2002

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Jack Ehnes
Chief Executive Officer